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A Guide to Estate Taxes and Planning

The federal estate tax is a tax on the transfer of property at death. The tax applies to net taxable estates over $600,000, after taking into account allowable deductions, such as deductions for charitable bequests and property passing to a surviving spouse.

By following the guidelines in this chapter, you can estimate your potential estate. If your estate may be subject to tax, you may want to start thinking about property transfers that may reduce or avoid the estate tax. A brief review of estate tax plans is at ¶39.6, and gift tax plans are discussed in Chapter 33.

¶39.1 What Is the Estate Tax?

The estate you built up may not be entirely yours to give away. The federal government and, in most cases, at least one state government stand ready to claim their shares.

Do you know what will remain for your family, your favorite charities, and your other beneficiaries? If you do not, you cannot intelligently estimate what you can give to each. To help you make such an estimate, we offer this general guide to federal estate taxation. It will alert you to the extent of estate tax costs, and help you plan for estate tax savings that you may discuss with your attorney.

The federal estate tax is a tax on the act of transferring property at death. It is not a tax on the right of the beneficiary to receive the property; the estate and the estate alone pays the tax, although the property passing to individual beneficiaries may be diminished by the tax.

Understand what the word *estate* means in estate tax law so that you do not underestimate the value of your taxable estate. The estate includes not only your real estate (foreign and domestic), bank deposits, securities, and personal property such as art objects, but can also include insurance, your interest in trusts or jointly held property, and certain interests you have in other estates.

¶39.2 Take Inventory

The first step in estate tax planning follows a simple business practice of taking inventory of everything you own. Listing your belongings takes thought, time, and a surprising amount of work. On your list you should include records of purchases, fire and theft insurance inventories, bankbooks, brokers' statements, etc. You should also include your cash, real estate (here and abroad), securities, mortgages, rights in property, trust accounts, personal effects, collections, and art works. Life insurance is includible if: (1) payable to your estate; (2) payable to others and you have kept "incidents of ownership" such as the right to change beneficiaries, surrender or assign the policy, or pledge it for a loan; or (3) you assign the policy and die within three years (¶33.9).

If you own property jointly with your spouse, your estate includes only one-half the value of the property.

If you had appraisals made of unusual or specially treasured items or collections, or property of substantial value, file such appraisals with your estate papers and then enter the value on your inventory.

There are some assets that you might not ordinarily consider as part of your estate. Nevertheless, include in your inventory any trust arrangements created by you in which you have: (1) a life estate (the income or other use of property for life); (2) income that is to be used to pay your legal obligations (support of a child, for example); (3) the right to change the beneficiary or his or her interest (a power of appointment); (4) the right to revoke a trust transfer or gift; and (5) a reversionary interest (the possibility that the property can come back to you).

Retirement benefits. The taxable estate generally includes benefits payable at your death from any of the following retirement plans: pension plan, profit-sharing plan, Keogh plan, individual retirement account, or annuity. However, the value of an annuity from an IRA or employer plan that is payable to a beneficiary other than your estate may qualify for a full or partial exclusion if IRA distributions began before 1985 or you separated from service before 1985; no exclusion is allowed to the extent of your own nondeductible contributions to the plan.

A full exclusion is allowed for IRA funds if you began taking distributions from the account before 1983 under a schedule that irrevocably set the form of benefits. If IRA distributions began in 1983 or 1984 and you irrevocably elected the form of benefits before July 18, 1984, a $100,000 exclusion is allowed.

If you began receiving distributions from an employer plan before 1983 under a schedule that irrevocably set the form of benefits, a full estate tax exclusion is allowed. If you separated from service in 1983 or 1984, a $100,000 exclusion is allowed if the form of benefits is not changed before death; this is true even if distributions did not begin until after 1984.

¶39.3 Finding the Value of Your Estate

When you have completed your inventory, assign to each asset what you consider to be its fair market value. This may be difficult to do for some assets. Resist the tendency to overvalue articles which arouse feelings of pride or sentiment and undervalue some articles of great intrinsic worth. For purposes of your initial estimate, it is better to err on the side of overvaluation. You can list ordinary personal effects at nominal value.

If you have a family business, your idea of its value and that of the IRS may vary greatly. Estate plans have been upset by the higher value placed on such a business by the IRS. You can protect your estate by anticipating and solving this problem with your business associates, accountant, and legal counsel.

If your business is owned by a closely held corporation, and there is no ready or open market in which the stock can be valued, get some factual basis for a figure that will be reported on the estate tax return. One of the ways to do this is by arranging a buy-sell agreement with a potential purchaser. This agreement must fix the value

of the stock. Generally, an agreement that binds both the estate and the purchaser and which restricts lifetime sales of the stock will effectively fix the value of the stock for estate tax purposes. Another way would be to make a gift of some shares to a family member and have value established in gift tax proceedings.

If a substantial part of your estate is real estate used in farming or a closely held business, your executor may be able to elect, with the consent of heirs having an interest in the property, to value the property on the basis of its farming or business use, rather than its highest and best use. The special use valuation, however, may not reduce the gross estate by more than $750,000. But this may mean substantial tax savings. This savings may be recaptured from your heir if he or she stops using the property in farming or business within 10 years of your death.

¶39.4 How the Estate Tax Is Applied

A single unified rate schedule applies to a decedent's estate and all post-1976 lifetime gifts *over* the annual gift tax exclusion. Under the unified gift and estate tax rate, the overall tax on your property holdings is theoretically the same whether or not you make lifetime gifts. In actual cases, however, lifetime gifts may reduce the potential overall tax because of the annual gift tax exclusion.

If you make no taxable gifts during your life, estimating estate tax on Form 706 is fairly easy. You start with the total market value of the property in the estate. This is called the gross estate. From the gross estate you subtract certain deductions. For example, charitable bequests are deductible. An unlimited marital deduction is allowed for bequests to a surviving spouse who is a U.S. citizen; *see* ¶39.5 for noncitizen surviving spouses. The net amount after deductions is your taxable estate. The unified credit is subtracted from the tax calculated on the taxable estate. Other credits, including the state death tax credit, further reduce the federal estate tax on your estate. *See* ¶39.5 for a sample computation of estate tax.

If you make taxable gifts after 1976, estimating your estate tax is more complicated. The estate tax and gift tax are cumulative. That is, the unified tax rate is applied to the sum of (1) your taxable estate at death, and (2) taxable lifetime gifts made after 1976 (other than gifts included in your estate). The tax you figure on both (1) and (2) is reduced by gift taxes payable on gifts made after 1976. The unified credit and other credits are then subtracted from the remaining amount.

Separate tax on accumulated retirement benefits. The law penalizes excess retirement account accumulations. If you die and leave too much in your retirement accounts, a special 15% tax may be imposed. The 15% tax applies if at the date of death the value of all your interests in qualified retirement plans, IRAs, annuity plans, and tax-sheltered annuities exceeds a test amount. The test amount is the present value of annual payments over an annual ceiling (currently $155,000) figured over your life expectancy immediately before death. There are exceptions and special computation rules figured on Schedule S of Form 706. If the 15% tax is applicable, it may *not* be offset by the unified estate tax credit or any other credit. Given the complicated formula for figuring the 15% tax, you should consult an experienced professional to help you determine how the tax could affect your overall estate tax planning.

Generation-skipping transfers. Transfers that "skip" a generation, such as a gift to a grandchild, are subject to a special tax (computed on Schedule R of Form 706) if they exceed a lifetime exemption of $1 million per transferor. Because of other exceptions and the complexity of these rules, you should consult an experienced tax practitioner if planning "skip" transfers.

¶39.5 Unified Tax Rates and Credit

The unified tax credit is $192,800. The amount of the credit is the same for gift tax and estate tax purposes. Applying it to the taxable estate, no tax applies to estates under $600,000.

These exempt amounts assume that you did not make any taxable gifts and that the taxable estate is your gross estate less allowable deductions.

The unified tax credit replaces the $60,000 estate tax exemption and $30,000 lifetime gift tax exemption allowed prior to 1977. Where part or all of the $30,000 lifetime gift tax exemption was used after September 8, 1976, and before January 1, 1977, the unified credit is reduced by 20% of the amount allowed as an exemption on those gifts. Thus, if you used the entire $30,000 exemption on a gift made after September 8, 1976, your unified credit is permanently reduced by $6,000 (20% of $30,000).

Phaseout of credit and graduated rates. The benefit of the unified credit and graduated rates is phased out for cumulative transfers (taxable gifts plus estates) above $10 million. The tentative estate tax liability figured on Form 706 is increased for estates between $10 million and $21,040,000. The increase is 5% of the excess of the estate over $10 million. Estates over $21,040,000 are taxed at a flat 55%. Taxable gifts after 1976 are added to the estate for purposes of computing the 5% adjustment.

YOU ARE NOW READY TO ESTIMATE THE FEDERAL ESTATE TAX

Gross estate (your estimated inventory)		$ ______
Less:		
1. Administration expenses (executor's commissions, attorneys' fees, etc.; estimate about 5% to 10% of your estate)	$ ______	
2. Debts, mortgages, liens	______	
3. Funeral expenses	______	
4. Marital deduction	______	
5. Charitable deductions	______	
Total of Lines (1)–(5)		$ ______
Your taxable estate		$ ______
Plus: Post-1976 taxable gifts (over the annual exclusion)		$ ______
Total taxable amount		$ ______
Tentative tax on total		______
Less:		
1. Gift tax payable on post-1976 gifts	$ ______	
2. Unified credit	$ ______	
3. State death taxes credit and other credits	$ ______	______
Estate tax due		$ ______

EXAMPLE

Assume an unmarried person who made no taxable gifts after 1976 leaves a gross estate of $700,000. Debts, administration, and funeral expenses total $60,000. The decedent bequeaths $160,000 to charity.

Gross estate		$700,000
Less: Debts, administration, and funeral expenses		60,000
		$640,000
Less: Charitable deduction		160,000
Taxable estate		$480,000
Tentative tax	$149,000	
Less: Unified credit	192,800	
Estate tax due		None

If there was an estate tax due after applying the unified credit, the tax may be reduced by the credit for state death taxes. There are also credits for foreign death taxes, gift taxes paid on gifts before 1977, and federal estate taxes paid on certain prior transfers.

Nonresident alien decedents and surviving spouses. For nonresident aliens, estate tax applies only to the part of the gross estate located in the United States. The estate and gift tax rates applied to U.S. citizens and residents also apply to nonresident aliens. However, the unified credit is limited to $13,000, exempting the first $60,000 of the estate from estate tax. Where required by a tax treaty, a proportionate part of the regular $192,800 unified credit is allowed, based on the percentage of the total gross estate that is situated in the U.S. Estates of certain residents of U.S. possessions are allowed a unified credit equal to the greater of $13,000, and $46,800 multiplied by the proportion of the gross estate situated in the U.S. to the total gross estate. *See* ¶39.6 for marital deduction restrictions.

Unified Gift and Estate Tax Rates

If taxable amount is:

Over—	*But not over—*	*The tax is—*	*Plus%—*	*Of the amount over—*
$ 0	$ 10,000	$ 0	18	$ 0
10,000	20,000	1,800	20	10,000
20,000	40,000	3,800	22	20,000
40,000	60,000	8,200	24	40,000
60,000	80,000	13,000	26	60,000
80,000	100,000	18,200	28	80,000
100,000	150,000	23,800	30	100,000
150,000	250,000	38,800	32	150,000
250,000	500,000	70,800	34	250,000
500,000	750,000	155,800	37	500,000
750,000	1,000,000	248,300	39	750,000
1,000,000	1,250,000	345,800	41	1,000,000
1,250,000	1,500,000	448,300	43	1,250,000
1,500,000	2,000,000	555,800	45	1,500,000
2,000,000	2,500,000	780,800	49	2,000,000
2,500,000	3,000,000	1,025,800	53	2,500,000
3,000,000		1,290,800	55*	3,000,000

**See also* the phase-out rule on the previous page.

¶39.6 Reducing or Eliminating a Potential Estate Tax

Here are general approaches to eliminating or reducing a potential estate tax: You can make direct lifetime gifts. Any appreciation on the property transferred will be removed from your estate. Furthermore, each gift, to the extent of the $10,000 per donee annual exclusion, reduces your gross estate; *see* ¶33.1 and ¶33.2. Life insurance can be assigned to avoid estate tax, provided the assignment takes place more than three years before death; *see* ¶33.9. You can provide in your will for bequests that will qualify for the marital and charitable deductions.

The marital deduction. A married person may greatly reduce or eliminate estate tax by using the marital deduction. Property passing to a spouse is generally free from estate or gift tax because of an unlimited marital deduction.

Weigh carefully the tax consequences of leaving your spouse all of your property. For maximum tax savings, you may want to give your spouse only enough property to reduce your taxable estate to the exemption floor (*see* ¶39.5). The unified credit will then eliminate tax on that amount at the time of your death. By leaving your spouse less than the maximum deductible amount, you may be able to reduce the estate tax at the time of his or her death.

To qualify for the marital deduction, the property must generally be given to the spouse outright or by other arrangements that are the legal equivalent to outright ownership. There is an exception for income interests in charitable remainder annuity or unitrusts and certain other qualified terminable interest property (QTIP) for which the executor makes an election.

Life insurance proceeds may qualify as marital deduction property. Name your spouse the unconditional beneficiary of the proceeds with unrestricted control over any unpaid proceeds. If your spouse is not given this control or general power of appointment, and there is no requirement that proceeds remaining on your spouse's death be payable to his or her estate, the insurance proceeds will not qualify for the marital deduction.

What should be done if you believe your spouse cannot manage property? You will not want to give complete and personal control. The law permits you to put the property in certain trust arrangements that are considered equivalent to complete ownership. Your attorney can explain how you can protect your spouse's interest and qualify the trust property for the marital deduction.

Marital deduction restrictions for noncitizen spouses. A marital deduction may not be claimed for property passing outright to a surviving spouse who is not a U.S. citizen. However, the marital deduction is allowed if the surviving spouse's interest is in a qualifying domestic trust (QDOT). At least one trustee must be an individual U.S. citizen or domestic corporation with power to withhold estate tax due from distributions of trust corpus. The trust must maintain sufficient assets as required by IRS regulations. For the marital deduction to apply, the executor must make an irrevocable election on the decedent's estate tax return. On Form 706-QDT, estate tax will apply to certain distributions of trust corpus made prior to the surviving spouse's death, and to the value of the QDOT property remaining at the surviving spouse's death. You should consult an experienced tax practitioner to set up a QDOT trust and plan for distribution provisions.

The estate of a nonresident alien is subject to estate tax only to the extent that the estate is located in the United States. A marital deduction may be claimed by the estate of a nonresident alien for property passing to a surviving spouse who is a U.S. citizen. If the surviving spouse is not a U.S. citizen, then the transferred interest must be in the form of a QDOT, as discussed in the left column.

Periodically review your estate plan. You are now aware of the costs of transferring an estate and of the amount of tax that may be levied. But no estate plan is ever really final. Economic conditions and inflation constantly change values. For this reason, your plan must be reviewed periodically as changes occur in your family and business, as when a birth or death occurs; when you receive a substantial increase or decrease in income; when you enter a new business venture or resign from an old one; or when you sell, retire from, or bring new persons into business. A member of your family may no longer need any part of your estate, while others may need more. Estate or gift tax laws may be revised, or material changes may occur in the health or life expectancy of one of your beneficiaries.

A final word of caution: Estate tax planning is not a do-it-yourself activity. We suggest you contact experienced counsel for help.

¶39.7 Estate Tax Freeze Advisory

The object of an estate tax freeze is to reduce or eliminate estate tax on the inheritance of property by fixing the value through certain property arrangements. A complicated gift and estate tax law (IRC §§2701–2704) attempts to discourage such plans by applying special valuation rules. The rules cover not only common and preferred stock holdings within the family but also partnership interests, the deferral of dividend payments on preferred stock, life and remainder interests, and buy-sell agreements in family businesses.

The estate freeze rules impose gift tax and estate tax values for property transfers subject to the law. Because of the complexity of these rules and their effect on gift and estate values, we suggest that you seek professional advice in the following situations:

- As an owner of a family business, you plan to give common stock to family members while retaining preferred stock or recapitalize with common and preferred stock.
- You plan to give up a voting interest or liquidating rights attached to preferred stock in a family business.
- You defer payment of dividends in preferred stock in a family business.
- You plan to retain an interest for life in a transfer or purchase of property.
- You plan to give stock to a family member in a company in which you have a buy-sell agreement.